Seeking Alpha α

15 For 17: A Strategy That Has Consistently Beat Market

Jan. 8, 2017 9:34 AM ET42 comments
by: Ploutos

Summary

- Two factor tilts from the S&P 500 - the Dividend Aristocrats and Equal Weighting - have historically beat the market benchmark.
- Combining these two indices in equal proportions has beat the S&P 500 in all but two years of the 21st century.
- The combination of these strategies has strongly outperformed the market benchmark.

In a recent series of articles, I highlighted five strategies for buy-and-hold investors that have historically beat the market. The fourth and fifth parts of this series are factor tilts that when combined have outperformed the S&P 500 with striking regularity.

The **Dividend Aristocrats**, S&P 500 constituents which have paid increasing levels of dividends for at least 25 consecutive years, have produced a return profile exceeding the broader market by 2.4% per annum over the past nearly three decades while exhibiting only three-quarters of the return volatility. The ProShares S&P 500 Dividend Aristocrats ETF (NYSEARCA:NOBL) closely replicates the Dividend Aristocrats.

The **S&P 500 Equal Weight Index** is a version of the S&P 500 where the constituents are equal weighted as opposed to the traditional market capitalization weighting of the benchmark gauge. The Guggenheim S&P 500 Equal Weight ETF (NYSEARCA:RSP) replicates this alternative weight index. When the equal-weighted version of the index is rebalanced quarterly to return to equal weights, constituents which have underperformed are purchased and constituents which have outperformed are reduced, a contrarian strategy that has produced excess returns relative to the capitalization-weighted S&P 500 index over long time intervals.

Equal-weighting also gives an investor a greater average exposure to smaller capitalization stocks, a risk factor for which investors have historically been compensated with higher average returns. Over a long time series dating back to the 1990, equal-weighting has beat the capitalization-weighted benchmark by 2.65% per year.

Index returns for the Dividend Aristocrats and the Equal Weight Index are detailed below. I compare a 50-50 weight of the two indices versus the total return of the S&P 500 (NYSEARCA:SPY).

Year	Equal Weighting	Dividend Aristocrats	50/50	S&P 500	Difference
2000	9.6%	10.1%	9.9%	-9.1%	19.0%
2001	-0.4%	10.8%	5.2%	-11.9%	17.1%
2002	-18.2%	-9.9%	-14.0%	-22.1%	8.1%
2003	41.0%	25.4%	33.2%	28.7%	4.5%
2004	17.0%	15.5%	16.2%	10.9%	5.3%
2005	8.1%	3.7%	5.9%	4.9%	1.0%
2006	15.8%	17.3%	16.6%	15.8%	0.8%
2007	1.5%	-2.1%	-0.3%	5.5%	-5.8%
2008	-39.7%	-21.9%	-30.8%	-37.0%	6.2%
2009	46.3%	26.6%	36.4%	26.5%	10.0%
2010	21.9%	19.4%	20.6%	15.1%	5.6%
2011	-0.1%	8.3%	4.1%	2.1%	2.0%
2012	17.7%	16.9%	17.3%	16.0%	1.3%
2013	36.2%	32.3%	34.2%	32.4%	1.8%
2014	14.5%	15.8%	15.1%	13.7%	1.4%
2015	-2.2%	0.9%	-0.6%	1.4%	-2.0%
2016	14.8%	11.8%	13.3%	12.0%	1.4%
Return	8.7%	9.8%	9.4%	4.5%	4.4%
Risk	20.9%	13.5%	17.0%	18.1%	

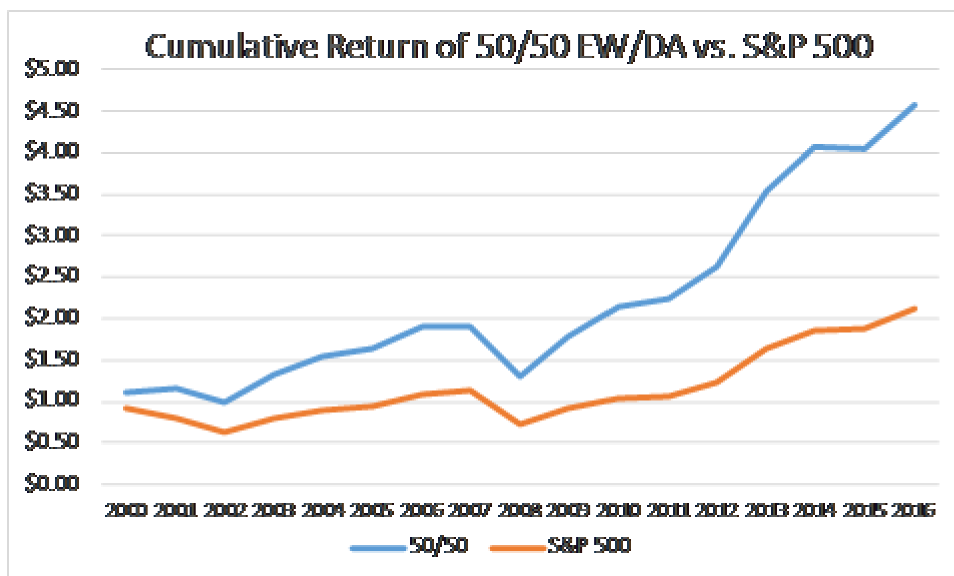
Return: Geometric Average Return

Risk: Standard Deviation of Annual Returns

The Dividend Aristocrats produced a disproportionate amount of their relative excess return versus the S&P 500 in falling markets (see 2002, 2008), and the equal-weighted index produced its relative excess returns in rising markets (see 2003, 2009), **combining their return profiles produces a risk profile that exceeds the broader market with less variability of returns**.

Combining these two strategies in equal proportions has bested the S&P 500 in 15 of the past 17 years. Singularly, the Dividend Aristocrats have beat the S&P 500 in 11 of the past 17 years, and the Equal Weighted Index has beat the S&P 500 in 13 of 17 years, but combining the two passive strategies in equal proportions has led to even more consistent outperformance.

How good has the outperformance of this strategy been? Any active fund manager beating the market for 15 of the last 17 years would have made himself a lot of money. The geometric average return of this strategy (+9.4%) beat the S&P 500 (+4.5%) by nearly 5% per year while exhibiting lower return variability.



Over this historically weak period for stock returns that featured two large drawdowns (tech bubble, Global Financial Crisis), a dollar invested in this strategy in 2000 would be worth $4.58 today while a dollar invested in the S&P 500 would be worth less than half that figure, just $2.12, even with the S&P 500 near all-time highs.

In each of the years that the S&P 500 produced negative returns in this sample period, the Dividend Aristocrats outperformed. The worst performance for the Dividend Aristocrats relative to the market has been in 1998, 1999, and 2007 - years that preceded down years for the market. Combining the Dividend Aristocrats with the equal-weighted index, which tends to outperform the market when it is sharply rising, provides a diversification benefit.

The 50/50 strategy's underperformance in 2015 was likely a function of the outperformance of the FANG stocks. Facebook (NASDAQ:FB) +34%, Amazon (NASDAQ:AMZN) +118%, Netflix (NASDAQ:NFLX) +134%, and Google (NASDAQ:GOOGL) (NASDAQ:GOOG) +47% were all among the top 10 contributors to the S&P 500's 2015 return. Since none of these stocks were even in existence for the full 25-year time horizon needed for inclusion in the Dividend Aristocrats, none were included in that half of this strategy.

They were of course relatively underweight in the equal weighting strategy relative to the capitalization weighting. I am fine underweighting these four companies that have a combined market capitalization of over $1.3 trillion, or roughly the value of all the goods and services produced in Australia in a year. They are great companies, but they are already commanding value as such.

I am pretty confident in saying that over the next 17 years, a combination of the Dividend Aristocrats and the Equal Weighted Index will have lower variability of returns than the broader market. Because the Dividend Aristocrats Index is populated by companies that are able to return increasing levels of cash to shareholders through both the peaks and valleys of the business cycle, this index has lower drawdowns in weak markets.

If we believe that this strategy will have lower relative risk to the broad market, will this strategy continue to generate excess returns? I believe that the Dividend Aristocrats will produce excess returns when adjusted for their lower risk over long time intervals. This strategy effectively overweights these high quality companies, capturing the Low Volatility Anomaly, and missing S&P 500 constituents that go out of business. I am sure that some astute readers will note that the Dividend Aristocrats have outperformed the combination with the Equal Weighted Index over the entire dataset. Adding the Equal Weighted Index enhances returns in bullish market environments, allowing the combination to be more consistent together.

While their risk-adjusted performance will remain strong, I do not expect that low volatility stocks, like the Dividend Aristocrats, will necessarily continue to outperform the broader market on an absolute basis. As long-time readers know, I believe that there are structural and behavioral reasons that Low Volatility strategies have generated structural alpha. I am very confident in future risk-adjusted outperformance, but less confident on absolute outperformance of these strategies prospectively.

The Dividend Aristocrats generated strong outperformance relative to the S&P 500 in the first half of 2016, and the market might be catching up to the idea that lower risk stocks are worth a premium, especially in uncertain market environments and a yield-starved world. Equal-weighting the stock constituents provides an uncorrelated source of alpha.

As I have written before, equal weighting the S&P 500 constituents is an alpha-generative contrarian strategy that also more effectively captures the "small(er) cap premium" than the capitalization weighted S&P 500, and I think that this part of this 50/50 strategy will be an increasing component of its outperformance prospectively.

For passive investors who want broad market exposure, understanding that changing your index weightings to a combination that overweights dividend growth stocks and equal weights the broad market benchmark has historically produced higher average returns with lower variability of returns. That's the alpha we are seeking.

Disclaimer: My articles may contain statements and projections that are forward-looking in nature, and therefore inherently subject to numerous risks, uncertainties and assumptions. While my articles focus on generating long-term risk-adjusted returns, investment decisions necessarily involve the risk of loss of principal. Individual investor circumstances vary significantly, and information gleaned from my articles should be applied to your own unique investment situation, objectives, risk tolerance, and investment horizon.

Disclosure: I am/we are long NOBL, RSP, SPY.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.